

## Washington; General Obligation

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# Washington; General Obligation

Credit Profile		
US\$343.54 mil Various purp GO bnds ser 2011B due 02/01/2036		
Long Term Rating	AA+/Stable	New
US\$90.41 mil GO bnds (Taxable) ser 2011T-2 due 02/01/2019		
Long Term Rating	AA+/Stable	New
Washington GO		
Long Term Rating	AA+/Stable	Affirmed

## Rationale

Standard & Poor's Ratings Services assigned its 'AA+' long-term rating to the state of Washington's \$343.5 million series 2011B various-purpose general obligation (GO) bonds and \$90.4 million series 2011T-2 (taxable) GO bonds. In addition, we affirmed our 'AA+' long-term rating and underlying rating (SPUR) on the state's outstanding GO debt. The outlook is stable.

The ratings reflect our view of the state's:

- Relatively well-educated workforce and good income indicators;
- Sales tax-based revenue structure that exhibits sensitivity to economic cycles, but to a lesser degree than those of states that rely primarily on personal and corporate income taxes;
- Historically good year-end reserve balances, including a constitutional budget stabilization account, the funding of which is prescribed by law;
- Strong financial policies and practices; and,
- Moderately high per capita debt burden and well-funded pension plans in aggregate, although it has two underfunded plans.

The state's full faith, credit, and taxing powers secure both new series of bonds. The state will have a total of \$16.8 billion GO bonds outstanding after the current offering. Of this, \$6.02 billion of the state's GO debt is first payable from state excise taxes on motor vehicle and special fuels.

In its 2011 legislative session, the Washington State Legislature confronts closing a projected \$4.6 billion general fund budget gap for the fiscal 2012 and 2013 biennium, which begins on July 1. A deficit of this magnitude is equivalent to approximately 15% of general fund spending during the fiscal 2010-2011 biennium, which will end on June 30. In December 2010, Governor Gregoire proposed a budget for the upcoming biennium that closes the deficit without increasing taxes while providing for a budget reserve of \$881 million, or 2.7% of total spending if all budget assumptions hold. More immediately, the state faces a lingering shortfall totaling \$335 million for fiscal 2011. To remedy this shortfall, in December 2010, the governor proposed a supplemental budget for the legislature to consider as a part of its 2011 session. The proposed supplemental budget calls for \$244 million in spending reductions and allows for the use of the state's budget reserve, which would bring the ending balance to \$98.6 million, equal to what we view as a low 0.66% of fiscal 2011 general fund spending.

Prior to the proposed supplemental budget, the state's revenue forecast council indicated in September and

November that revenues could be almost \$1.2 billion below previous expectations through fiscal 2011. The governor's imposition of 6.3% across-the-board cuts to state spending in October proved insufficient, and after successive rounds of negative revisions to state general fund revenues totaling approximately \$2 billion since March of 2009 she called for an extraordinary one-day legislative session. The legislature adopted \$588 million of budget solutions in the December meeting.

Achieving budget balance in fiscal years 2012 and 2013 is complicated by a decline in federal fiscal stabilization funding (representing \$2 billion of the state's fiscal problem), upward pressure on social services due to the recession (\$2 billion), increasing pension contribution requirements in the absence of reform (\$584 million), and the elimination of some temporary taxes via voter initiative (\$218 million in addition to \$63 million during the remainder of fiscal 2011).

The governor's proposals include a mixture of austerity measures including, notably, the elimination of the state's subsidized health insurance plan for low-income residents (saving \$230 million in state funds) and disability lifeline grant program (saving \$327 million). Suspension of voter-approved initiatives for smaller class sizes and to support teacher pay increases produce \$1.1 billion in savings. The budget proposal also includes a certain amount of nonrecurring measures, such as shifting back, by one day, to fiscal 2012 a \$253 million payment to K-12 schools.

Pension reform is among the significant proposals the governor is putting forward. Taken together, the reforms would produce an estimated \$425 million in savings for the state during fiscal years 2012 and 2013. By ending the automatic inflation-based benefits increases for beneficiaries of the state's two significantly underfunded and, since 1977, closed pension plans, the unfunded actuarial accrued liability (UAAL) of approximately \$7 billion would be reduced by more than 50%. The state's other pension plans, viewed on a combined basis, have a funded ratio of 119%.

Washington's economy is tracking the nation's gradual U-shaped emergence from the recession, which technically ended in June 2009. The state's revenue forecast is premised on national GDP growth in 2011 of 2.5%, which is consistent with our expectation. Job growth, according to the forecast, is also projected to mirror the nation at 1.2%. Even though they account for only 5% of the state's workforce, the software and aerospace sectors are projected to represent 14% of total growth in personal income through the forecast horizon (2013). High-paying jobs with both of the state's largest employers, Microsoft and Boeing, support the forecast's call for a personal income growth rate in excess of that of the U.S. through the forecast's timeframe despite a similar overall rate of job growth. Construction employment is still down and somewhat limits the state's recovery, although the trend in building permits has stabilized. The extent of the drop-off in the sector is evidenced by the forecast, which indicates that even through its horizon, total construction jobs are expected to remain approximately 45,000 below their peak in 2007.

Despite a projected 3.7% personal income growth in 2011, the revenue forecasts a much higher 7.3% increase in general fund revenues. The strong rebound would follow two consecutive years in which state general fund revenues declined 9.6% and 4.1%, respectively. Although a portion of the anticipated growth rate is attributable to the state's temporary 0.3% increase to the business and occupation tax as well as, according to the state, pent-up demand, we believe it is possible the revenue recovery may be more gradual. Recent data from the S&P/Case-Shiller Home Price Index place the Seattle metropolitan area among the bottom quartile of performers, with a negative 4.1% year-over-year change in home prices through October 2010. We believe ongoing softness in the real estate and construction may largely offset the state's strong export performance. State revenues, which depend on consumer

activity via its retail sales tax (47% of total tax revenues), could be restrained by residents more focused on repairing their personal balance sheets and increasing savings than returning to pre-recession levels of spending. A backlog of aircraft orders from Boeing represents several years of strong activity and is from a diversified customer base. With only 19% of orders from troubled European countries and 68% from nations in the Americas, Asia, and the Middle East, economic risk to the business is limited. Boeing's less severe experience through the recent recession (5,000 layoffs) pales compared to the 2001 recession (50,000 layoffs), suggesting that jobs are likely to be restored at a more tempered pace.

Washington's financial liquidity remains adequate despite negative general fund cash balances in fiscal 2011. General fund cash balances were negative throughout fiscal 2010 as well, but to a lesser extent. As of December 2010, the general fund cash deficit stood at approximately negative \$1 billion. The state also has liquidity in its treasury and treasury trust funds, which include funds that both are and are not subject to legislative appropriation. This cash is held in the custody of and invested on a comingled basis by the state treasurer. As of December 2010, the treasury and treasurer's trust funds cash balance was \$3.28 billion. Investments are conservative, with over 50% of funds invested with U.S. Treasury and agencies. Repurchase agreements, which are subject to a maximum term of 180 days, represent 38.1% of investments. In addition to the state's investment guidelines, state policies require that collateral in repurchase agreements for U.S. Treasury, agency, and money markets be priced at 102% of market value. Mortgage-backed repurchase agreements of over seven days are subject to a higher 105% requirement.

As of June 30, 2009, the actuarial accrued liability (AAL) of the defined-benefit portion of the state's 13 pension plans totaled \$61.8 billion, of which actuarial assets (\$57 billion) in aggregate accounted for 92%. However, we note that funds from one plan cannot make up for shortfalls in another and that the state's Public Employees Retirement System Plan 1 and Teachers Retirement System Plan 1 together represented 40% of the state's AAL and were funded at what we consider to be low 70% and 75% ratios, respectively. The state's other postretirement employee benefit (OPEB) liability consists primarily of an explicit subsidy of Medicare Parts A and B payments and totaled \$4 billion as of the latest published valuation report, on Jan. 1, 2008. The nonactuarial cost for retiree benefits was \$86 million in fiscal 2009, as compared with the \$332 million actuarially required payment (about 2% of expenditures) needed to amortize the liability as of the latest valuation.

The state's direct tax-supported debt burden (GO and appropriation-backed) is moderately high, in our opinion, at \$2,388 per capita, 5.34% of total personal income, and 5.0% of gross state product. Gross GO and lease appropriation-backed debt service is also moderately high, at 6.6% of general fund expenditures in fiscal 2010. Portions of the state's debt are funded from self-supporting or reimbursable sources. When adjusting for these offsetting revenues, debt service is moderate, at 4.2% of general fund expenditures. We expect that continuing transportation needs, including two major urban highway projects, will likely translate into continuing GO issuance in the medium term. The state currently projects that it may issue \$1.87 billion in new GO bonds and \$59 million in new certificates of participation debt during 2011.

Unlike a majority of states in the U.S., Washington maintains a positive balance in its unemployment insurance fund of \$2.34 billion.

Based on the analytic factors we evaluate for states, on a scale of 1 (strongest) to 4 (weakest), we have assigned a composite score of '1.8'.

## Outlook

The stable outlook reflects our view that the state's financial management is strong, as demonstrated by its continued willingness to make timely and proactive budget amendments as it deems necessary to maintain budgetary balance. We believe that automatic budget stabilization fund deposits and federal grants have absorbed much of the effects of the recession on state revenues and that recent budget actions will likely allow the state to maintain what we consider to be an adequate budgetary balance and liquidity position through the end of the biennium. An improved credit profile could result if, over the next two years, we believe that the state has substantially and sustainably improved its financial position. But we also believe that successive rounds of expenditure reductions and the current economic climate make further spending cuts or tax increases more difficult, and that credit quality could come under pressure over the upcoming two-year period if the state is unable to adjust its budget in response to a revenue recovery that is weaker than forecast.

## Governmental Framework

Managing toward ongoing fiscal solvency is encouraged by the state's statutory requirement to adopt a balanced budget and its discretion, subject to a majority vote of the legislature, to adjust the major components of its revenue base. Legal protections for the state's GO debt include a specific constitutional requirement that the legislature make appropriations in the budget for the interest and principal installment payments on its debt. Although the state does not offer debt a specific status, no other payment obligation enjoys a specific requirement that an appropriation be made. This has the practical effect of providing debt service with a strong legal position among the state's various payment obligations, in our view. Limited disbursement autonomy in other areas and its active voter initiative environment complicate the state's governmental framework. Similar to many other states, significant spending areas in the state's budget are largely nondiscretionary. The state approximates that as much as 60% of spending, primarily for K-12 education, Medicaid and foster care, and debt service and pensions, is effectively legally required by some combination of state constitution, statute, court decision, or federal mandate. In addition, Washington is an active voter initiative state and over the years, voters have approved initiatives that have reduced revenue and spending autonomy of the state. In the current budget cycle, a voter initiative added \$281 million to the state deficit (through fiscal 2013) by repealing certain temporary taxes the legislature had adopted as a component to balancing the state budget. Other initiatives (I-732 and I-728, for example) mandate spending for certain purposes, such as education. Washington's initiative process allows the legislature to suspend initiatives two years after passage with a majority vote of the legislature, which it has done with regard to significant education-related initiatives in recent biennial budgets. On a scale ranging from 1 (strongest) to 4 (weakest), we have assigned a score of '1.8' to Washington's governmental framework.

## Financial Management

Washington adheres to what we consider generally strong budget management practices. Across different gubernatorial administrations, when confronted with projected budget gaps, the state's political leadership has demonstrated a willingness to consider difficult fiscal adjustments, including both expenditure and revenue measures. In addition, when deficits emerge mid-cycle, the state has generally responded with timely corrective actions. Revenue projections are apolitical and developed according to the state's independent revenue forecasts.

When deficits do emerge, however, the state tends to include nonrecurring measures among its solutions and its updates to actual fiscal performance, considering both revenue and spending trends are not regularly available at intra-year intervals. On a scale ranging from 1 (strongest) to 4 (weakest), we have assigned a score of '1.5' to Washington's financial management.

## Economy

Washington's economy enjoys several fundamental strengths, including an above-average education level among its populace (30% of whom have bachelor's degree or higher). Other positive features of the state's economy are its consistently strong population growth trends (more than 4% higher than the U.S.), relatively low age-dependency ratio (55.4), high per capita gross state product (GSP; 110% of the nation), and high per capita incomes (111% of the U.S.). Economic development prospects remain good. In addition to the aforementioned health of Boeing, the state is also home to a vibrant high-technology sector, particularly in and around the Seattle MSA. In addition to Microsoft, the state's second-largest private sector employer, there are approximately 4,200 software companies in the state. Microsoft reported record profits in the third quarter of 2010, and after the software sector saw its first annual decline of jobs (2,400) in 2009, during 2010 the sector grew by over 1,200 jobs. The outlook for economic growth is currently favorable due to strong rates of expansion in China and other Asian economies. Washington's economy is trade-intensive and frequently is at the top of per capita measures of export value. Although during the past five years, the state's annual rates of GSP growth have exceeded those of the nation's, in five of the past 12 years, national GDP grew at a faster clip, indicating some propensity for economic volatility. On a scale ranging from 1 (strongest) to 4 (weakest), we have assigned a score of '1.4' to Washington's economy.

## Financial Management Assessment: 'Strong'

We consider the state's management practices "strong" under our Financial Management Assessment (FMA) methodology. An FMA of "strong" indicates our view that practices are strong, well embedded, and likely sustainable. The state Economic and Revenue Forecast Council, which is made up of representatives appointed by the governor's office, both houses of the legislature, and both political parties, produces an analytical report on economic and revenue performance each month and by statute presents quarterly revenue forecasts covering the current and upcoming biennium. The state uses the council's forecasts, which are based on a modified IHI Global Insight model of the U.S. economy, to set revenue parameters at biennial budget adoption and has a record of making budget adjustments within the biennium when the forecast council materially changes its projections. In addition, the state convenes a Caseload Forecast Council three times per year that forecasts service requirements in such areas as public assistance, state corrections, medical assistance, and K-12 education. The executive branch uses these forecasts, along with historical expenditures, to formulate budget proposals and mid-biennium revisions. Further guiding budgeting decisions is a rolling four-year general fund outlook maintained by the governor's Office of Financial Management. The state uses these forecasts to quantify the timing and scope of potential deficits in the subsequent biennium and in some cases to begin to address structural imbalances before the next budget cycle begins. Although the state does not have a minimum reserve policy, the state constitution requires the state to set aside 1% of most unrestricted state revenues in each fiscal year into a budget stabilization fund, a form of "rainy-day" fund. That fund can and is being tapped in the current biennium under a provision that the state can draw on the fund when employment growth falls below 1% and is also available in the event of a catastrophic emergency, or by 60% supermajority vote of the legislature. When it reaches 10% of estimated general state

revenues in that fiscal year the state can also draw excess funds for education capital projects.

Other policies and practices include:

- Capital spending that the state budgets for on a biennial schedule but plans on a rolling 10-year basis, including funding sources;
- A formal investment management policy that covers eligible investments, maximum maturities (10 years), allocations of nongovernment securities, and internal and external controls; and
- Debt management under an issuance policy that, among other elements, addresses refunding savings thresholds.

## Budget Performance

The state has a strong track record of maintaining good reserves, but the recession's toll fully materialized in the state's budget reserve by fiscal 2010. At June 30, 2010, however, the state's ending unreserved fund balance eroded to \$303 million, equal to a low 1.3% of expenditures (GAAP basis). The state's unrestricted balance ended the year in a negative position (\$561 million), reflecting the depleted cash liquidity in the general fund. Total fund balance at the end of fiscal 2010 was only modestly higher, at \$379 million, or 1.6% of expenditures. The state's balance sheet is weaker in fiscal 2011 as its economy works through the apparent gradual end of the recent recession. For much of the decade, the state's unreserved fund balance was in the range of 8% to 10% of annual expenditures. During expansionary phases of the economic cycle, the state consistently returns operating surpluses and good reserve positions. State authority to defer payments, to borrow from the treasury and treasurer trust funds, and, if needed, to issue cash flow notes all serve as contingency liquidity measures, but they have not been needed thus far. The state's absence of a formal policy for its budget reserve level allows for low balances to persist through protracted periods of economic and revenue softness.

The state's reliance on retail sales and business and occupation (gross receipts) taxes for a combined 68% of general fund tax revenues typically afford more revenue stability than other states, many of which rely on personal income tax revenues. Spending priorities are regularly evaluated through the state's "priorities of government" approach to zero-based budgeting. Independent and formal revenue and caseload forecasts inform budget decisions, and political leaders have demonstrated a willingness to make difficult adjustments when necessary. On a scale ranging from 1 (strongest) to 4 (weakest), we have assigned a score of '1.9' to Washington's budget performance.

## Debt And Liability Profile

As noted, Washington's debt is moderately high by several of our measures. Debt paydown is average, in our view, with 48% of outstanding principal amortized over 10 years. Other long-term state liabilities for pension and retiree health care are also above average. Taken in aggregate, the state's pension plans are funded at 92%, which we consider strong. The state's total UAAL for its pension plans is \$4.94 billion, equal to \$719 per capita, which we view as above average; and relative to total personal income, it is just 1.6%, which is strong, in our view. Contributions to pension funding are generally less than the actuarial required contribution (ARC) and for fiscal 2010, total actual contributions were 52.5% of the ARC.

In addition, the state offers OPEBs. According to the state's latest valuation, the statewide total unfunded postemployment benefit liability was \$7.6 billion as of Jan. 1, 2009, assuming a 4.5% discount rate. The state's OPEB includes an implicit liability from allowing retired employees to purchase health, life, and vision insurance in

the same pool as current employees at a subsidized rate. The explicit benefit subsidizes retired members' monthly premiums for enrollment in Medicare parts A and B. On an actuarial basis, the state's portion of the actuarial accrued liability made up \$3.8 billion of the total, and the annual required contribution was \$349 million of the statewide \$706 million for inactive and active members. According to the most recent published actuarial valuation report from reflecting data as of January 2008, the state's \$332 million in actual contributions (about 2% of annual expenditures), \$256 million represents the state's explicit subsidy, \$73 million is in the form of an implicit rate study, and \$3 million is attributable to life insurance. In fiscal 2009, the state contributed \$86 million for current pay-as-you-go expenses of the retiree benefits. We understand that the state does not plan to fully fund the annual required contribution for the foreseeable future.

Actual contributions to the pension plans, at \$984 million, are equal to 4.2% of general fund expenditures. On a combined basis, gross debt service and pension contributions costs equal 10.8% of general fund expenditures (8.4% when considering self-support and reimbursable debt service funding sources). Full pension ARC and gross debt service would equal 14.6% of expenditures (12.2% when considering self-support and reimbursable debt service funding sources). If the ARC for OPEBs were funded, the combined ratio would be 16.1% (13.7% when considering self-support and reimbursable debt service funding sources). On a scale ranging from 1 (strongest) to 4 (weakest), we have assigned a score of '2.3' to Washington's debt and liability profile.

## Related Criteria And Research

USPF Criteria: State Ratings Methodology, Jan. 3, 2011

Ratings Detail (As Of January 11, 2011)		
Washington mtr veh fuel tax go bnds ser 2004C dtd 08/06/2003 due 06/01/2009-2030		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
Washington GO		
<i>Long Term Rating</i>	AA+/Stable	Affirmed
Washington GO bnds		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
Washington GO Mtr Veh Fuel Tx		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
Washington GO (wrap of insured) (AMBAC) (ASSURED GTY - SEC MKT)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
Washington GO (wrap of insured) (FGIC & AGM) (SEC MKT)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
Washington GO (Motor Vehicle Fuel Tax)		
<i>Long Term Rating</i>	AA+/Stable	Affirmed
<b>Washington GO</b>		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		



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